Mutual Fund Category Analysis June 27, 2012

MF Category Analysis - Technology Sector Funds

Key Takeaways:

The Schemes belonging to Equity Technology Category posted muted performance over the short term given the global economic uncertainties which hampered the revenue growth visibility of most IT players. Over long term, a mixed performance was witnessed.

The IT industry body - NASSCOM forecasted that the Indian IT-BPO services exports expected to grow by 11-14% (US dollar terms) in FY13 while domestic services to grow by 13-16% (in Rs terms). India's IT services reported 16.7% growth in FY12 and 16.3% growth in FY11.

Meanwhile, the factors such as discretionary spending, pricing, internal dynamics, rising wage costs, protective policies of developed countries, visa issues, expensive valuations, slow decision making and tough competition dampened the performance of the IT companies, despite the fact that the depreciation in the rupee value against dollar lifted the operating margins of the companies.

The short term outlook for the sector continues to be gloomy given the present uncertain global situation. However, high risk profile investors who understand the IT sector and its moves can consider investing in the schemes through staggered investment options like SIP and hold for at least 2 years.

What are Technology Funds: Equity Sector – Technology funds invest predominantly in technology and technology dependent companies including hardware, peripherals and components, software, telecom, telecommunications, media and entertainment, internet and e-commerce and other technology-enabled companies.

These funds are commonly classified as sector funds as they allocate their investments in the stocks which belonging to a particular sector. These sector categories are riskier than other categories in the mutual fund due to their narrow asset allocation pattern.

The performance of these schemes are cyclical in nature and sensitive to change in the drivers in the respective sectors. The schemes managed to deliver good returns in times when their respective sectors or industries performed well.

Mutual Fund Category Analysis contd…

Relative performance of the schemes that belong to Technology sector:

Scheme	Latest Corpus (Rs Crs)	Expense Ratio (%)	Trailing Returns (%)						SD	Sharpe	Alpha
			1 Month	3 Month	6 Month	1 Year	3 Year	5 Year			
ICICI Pru Technology Fund (G)	**105**	**2.49**	**3.56**	**0.27**	**11.90**	**4.31**	**26.94**	**1.95**	**1.33**	**0.01**	**0.04**
Franklin Infotech Fund - (G)	**114**	**2.47**	**3.68**	**-4.68**	**1.29**	**0.00**	**21.60**	**3.96**	**1.56**	**-0.01**	**0.00**
SBI Magnum SFU - Infotech Fund	43	2.50	3.42	-4.25	3.95	2.12	22.25	-2.53	1.55	0.00	0.01
Birla Sun Life New Millennium	50	2.50	3.40	-3.66	2.09	-4.12	8.64	-4.24	1.41	-0.02	0.01
DSP BR Technology.com (G)	46	2.49	3.37	-5.91	-1.30	-11.23	10.34	-1.39	1.39	-0.04	-0.03
Equity - Banking	-	2.34	8.16	-2.12	19.00	-4.57	13.62	13.18	1.37	0.02	0.00
Equity - Diversified	-	2.25	4.33	-1.92	11.08	-2.69	9.78	4.25	1.06	-0.02	0.00
Equity - FMCG	-	2.48	4.81	12.48	24.23	32.08	37.34	20.67	0.84	0.12	0.07
Equity - Infotech	-	2.49	3.48	-3.65	3.59	-1.78	17.95	-0.45	1.45	-0.01	0.01
Equity - Pharma	-	2.28	1.49	4.69	9.83	3.33	25.83	11.40	0.71	0.00	-0.01
Sensex	-	-	5.90	-1.30	7.33	-3.29	5.81	3.24	-	-	-
Nifty	-	-	5.87	-1.58	8.71	-2.50	6.70	3.89	-	-	-
BSE IT	-	-	3.52	-5.80	-0.29	-1.33	20.38	3.11	-	-	-
BSE Tech	-	-	3.70	-6.23	-1.36	-5.71	8.41	-2.29	-	-	-

Note: Trailing Returns up to 1 year are absolute and over 1 year are CAGR. NAV/index values are as on June 22, 2012.

The highlighted schemes in the above table are recommended schemes from the Technology category.

The sector funds are high risk – high return funds. They are more risky than diversified equity funds. Diversified equity funds mitigate the downside risk by diversifying their portfolios across sectors, while the sector funds are exposed to higher risk as they are narrow in terms of asset allocation on particular sector.

Further, diversified equity funds have the leeway not only to pick the best performing and growth sectors but also to exit poor performing sectors. But in case of sector funds, they have a mandate to invest only in the sectors as specified in their offer documents and to adhere to the objective irrespective of market conditions.

The below table shows that all the sector categories outperformed large cap equity diversified categories for all the years.

Mutual Fund Category Analysis contd…

Performance of various mutual fund categories – YoY returns:

Category	2006	2007	2008	2009	2010	2011	2012 YTD
Equity - Banking	25.04	71.72	-41.82	84.23	37.41	-31.87	24.96
Equity - FMCG	15.09	35.57	-38.95	65.81	36.50	10.57	21.93
Equity - Auto	11.92	-0.97	-48.77	132.13	26.56	-19.28	19.09
Midcap	33.07	66.13	-61.47	103.16	22.71	-25.27	15.67
Large Cap	40.17	57.52	-52.24	79.03	17.84	-23.65	10.83
Equity Theme - Infrastructure	49.26	81.93	-58.42	81.11	6.69	-33.29	9.92
Equity - Media	44.38	83.56	-62.44	70.71	15.58	-18.97	8.46
Equity - Pharma	12.54	22.87	-36.38	89.87	32.79	-8.71	6.86
Equity - Infotech	47.52	16.09	-58.89	115.88	26.83	-18.53	2.71

1st Rank | 2nd Rank | 3rd Rank

Even though the sectors funds have a potential to fetch better returns for a particular period than equity diversified funds based on developments in the sectors, one can not expect consistent returns over periods from the funds since their investment strategy hovers within a limited sphere.

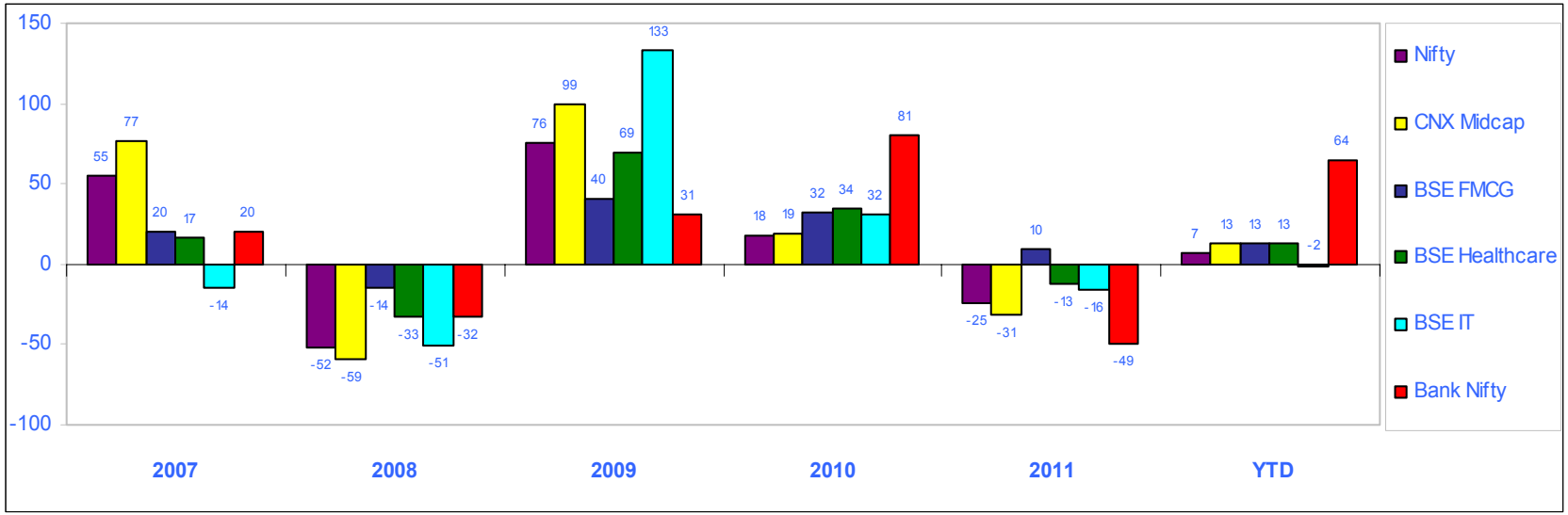
The sector fund performance moves in cycles. Every cycle will have a new out-performer and an under performer. For example, the Information Technology sector was at a peak while compared to other sectors during the year 2005-06. But it was seen at the bottom during 2007-08. The sector came to the top slot in 2009 again. Likewise, 2007-08 was the best performing period for infrastructure industry. But recent periods show that this sector is currently out of favour. The banking sectors outperformed during 2009 but underperformed in 2010.

Hence, the performance of these funds is linked to the fortunes of the sectors. The funds do well if the respective sectors perform well. Interestingly, some of sector funds over the long run outperform even the diversified equity funds.

Mutual Fund Category Analysis contd…

Yearly performance of key indicators of various sectors:-

(Absolute Returns in %)



Technology Sector Funds:

There are five schemes that invest predominantly in the IT stocks such as Birla Sun Life New Millennium Fund, DSP BR Technology.com, Franklin Infotech Fund, ICICI Pru Technology Fund and SBI Magnum SFU - Infotech Fund. Franklin Infotech Fund and ICICI Pru Technology Fund are more concentrated as far as asset allocation is concerned as both the schemes invest only in software stocks. Birla Sun Life New Millennium Fund, DSP BR Technology.com and SBI Magnum SFU - Infotech Fund are the schemes have been broad within the sub-categories investing along with software in Hardware, Entertainment & media Software and Telecom services.

Technology Sector:

IT industry has been one of the most significant growth contributors for the Indian economy. It has played a significant role in transforming India's image from a slow moving bureaucratic economy to a land of innovative entrepreneurs and a global player in providing world class technology solutions and business services. The industry has helped India transform from a rural and agriculture-based economy to a knowledge based economy.

Mutual Fund Category Analysis contd…

India is one of the biggest IT capitals in the modern world and has presence of all the major players in the world in IT sector. HCL, Wipro, Infosys and TCS are few of the household names of IT companies in India.

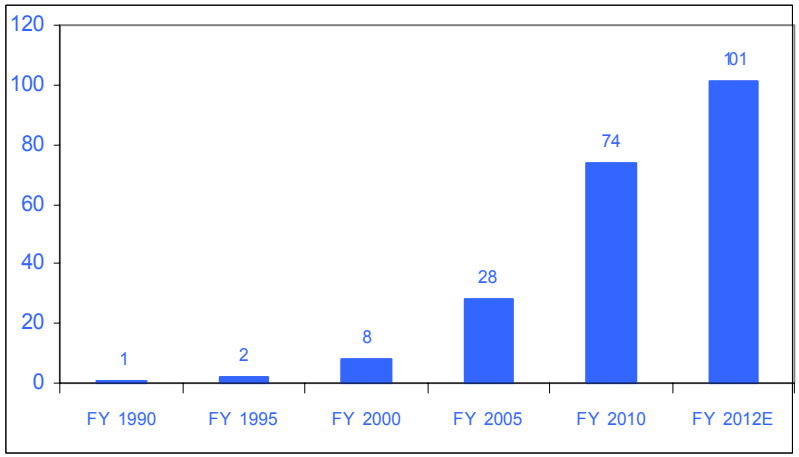
US and other foreign firms have been drawn to India by its vast English-speaking workforce and lower labour costs.

IT-ITeS sector in India has aggregated revenues of USD 88.1 billion in FY2011, while generating direct employment for over 2.8 million people. (Some 230,000 jobs had been added in the 2011/12 financial year). Out of USD 88.1 billion, export revenues (including Hardware) has reached USD 59.4 billion in FY2011 while domestic revenues (including Hardware) of about USD 28.8 billion.

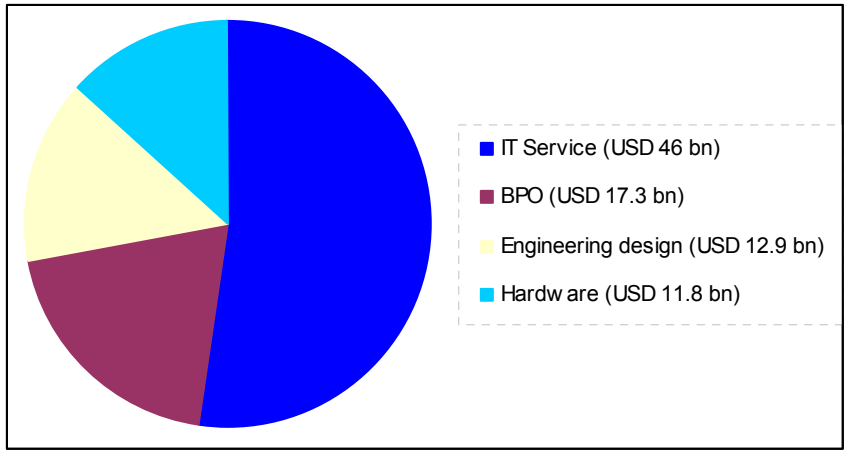
The IT industry body - NASSCOM has forecast that the Indian IT-BPO services exports is expected to grow by 11-14% (US dollar terms) in FY13 while domestic services could grow by 13-16% (in Rs terms).

The IT sector is expected to generate revenues of USD 130 billion by 2015 and USD 225 billion by 2020, which will create a transformational impact on the overall economy. India held around 58% of the global outsourcing market in 2011, up from 55 percent in 2010.

Indian IT PBO Industry Revenue (USD bn)



Segments wise revenue during FY 11:



Mutual Fund Category Analysis contd…

Growth Drivers

- Strong competitive position with high market share.
- Huge talent pool.
- Well established delivery centres across the world.
- Cost and tax advantages.
- Encouraging Government policies.
- Strong growth in export demand from new verticals and the non-traditional sectors.
- Increased IT adoption in key sectors such as Telecom, Manufacturing and BFSI.
- SEZs will drive growth in the Indian IT sector as more of SEZs are now being set up in Tier II cities and about 43 new tier II/III cities are emerging as IT delivery locations.

More recently, online retailing, cloud computing and e-commerce are the major driving forces behind the rapidly increasing growth in the IT industry. Online shopping has increased with the emergence of internet retailing and e-commerce.

Challenges:

Some of the key challenges that the industry facing at present are,

Uncertainty: Key markets like Europe are still in the throes of a crippling recession. As recent data revealed, the UK has slipped back into a recession. Given this environment, Indian IT companies are finding it tough to get a fix on deal visibility and hence struggling with their results guidance.

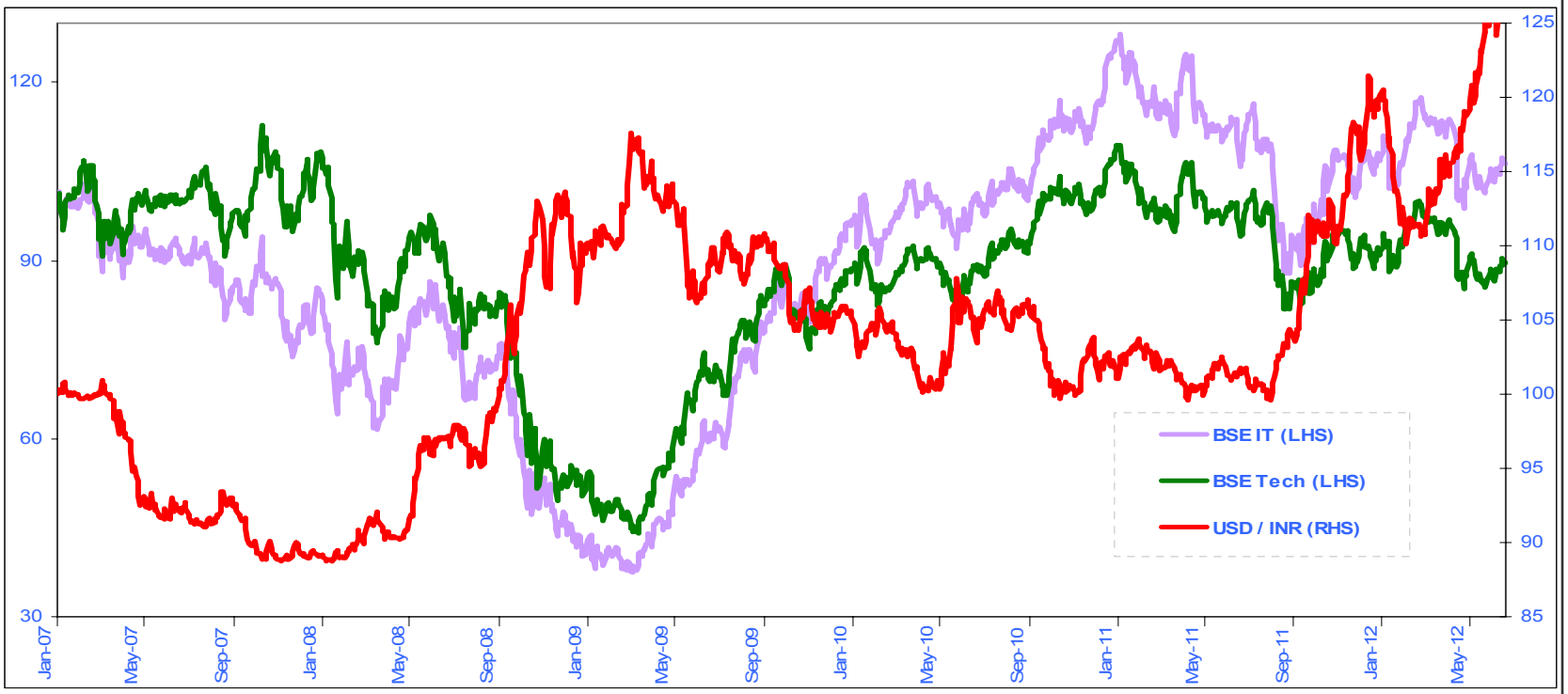
Slow in decision making: Decision making on deals by the clients is likely to be slow for next quarters (which TCS and Wipro indicated in the last quarter of 2011-12 in the post-results commentary) given in the uncertain economic environments in large markets like US and Europe.

Tough competition: Indian companies are now fighting with MNC giants like Accenture and IBM even for smaller contracts, which the latter would not go after earlier as aggressively. Further, clients are demanding new pricing models, a presence across geographies and greater sharing of risk from Indian vendors. Contracts are being renegotiated regularly.

Mutual Fund Category Analysis contd…

Further, currency volatility, slower growth in discretionary spends, lower volume increases, along with reduced utilization rates also impede revenue growth of the industry. The protectionist policies of western countries and visa restrictions are another cause of concern. Though the short term outlook for the sector seems to be not very attractive, outperformance by large cap companies in the sector going forward can bring better return over medium to long term.

Correlation among USD/INR and key IT indices:



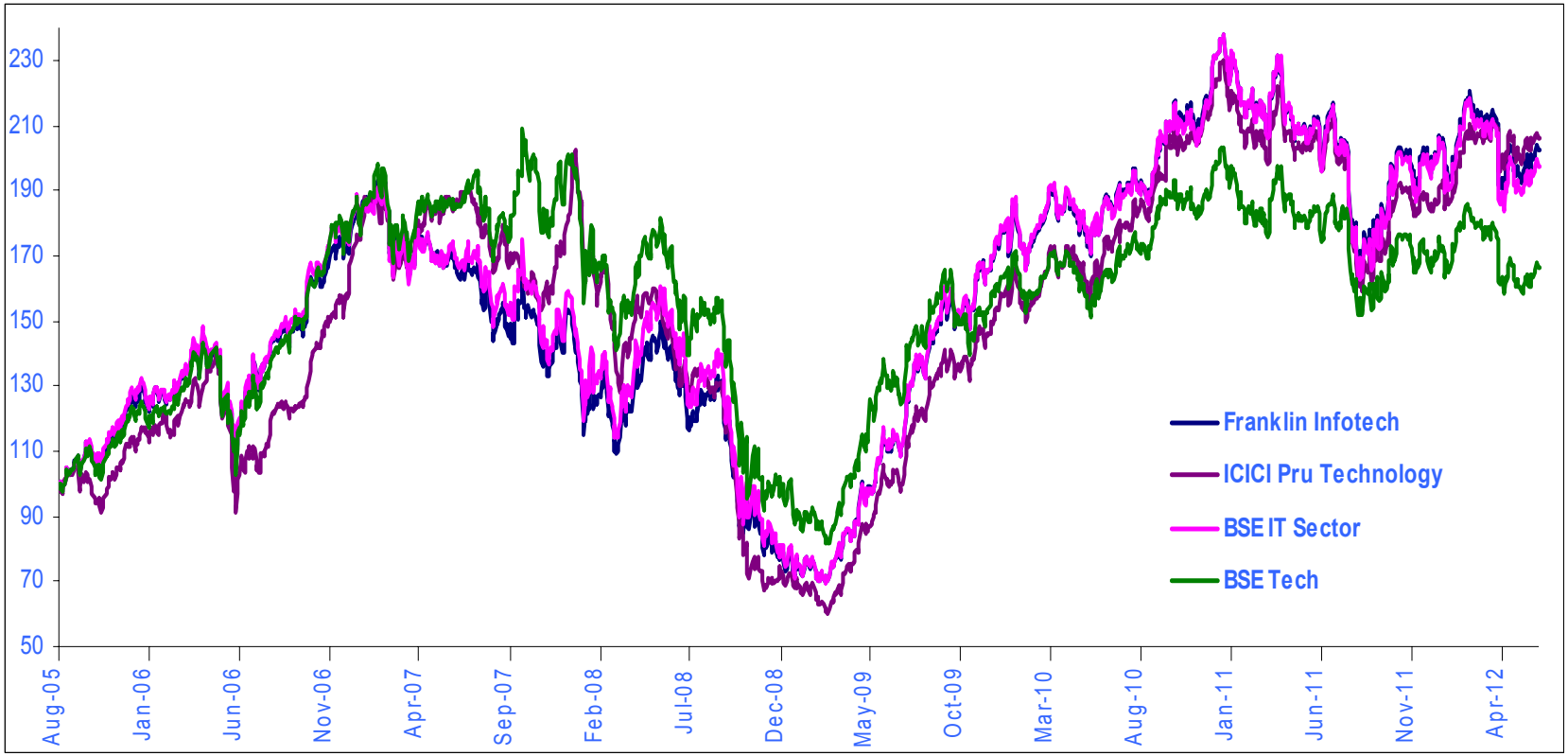
Contrary to popular impression, the IT indices do well when the Rupee appreciates vs the US$. This is due to the fact that when global economic situation improves (and the visibility for the IT sector improves), the emerging currencies also improve vis-à-vis the US$.

Mutual Fund Category Analysis contd…

Performance:

The category posted sluggish performance over the short term as well as long term periods and underperformed its counter parts such as Banking, Pharma and FMCG categories. However the performance over last 3 year period has been notable as it outperformed equity diversified and Banking categories by generating 18% CAGR returns. ICICI Pru Technology and Franklin Infotech are the best performing schemes from the category. The performance by the schemes is mainly attributable to their major allocation into the sub category of Software.

Performance of best performing schemes in the category:-

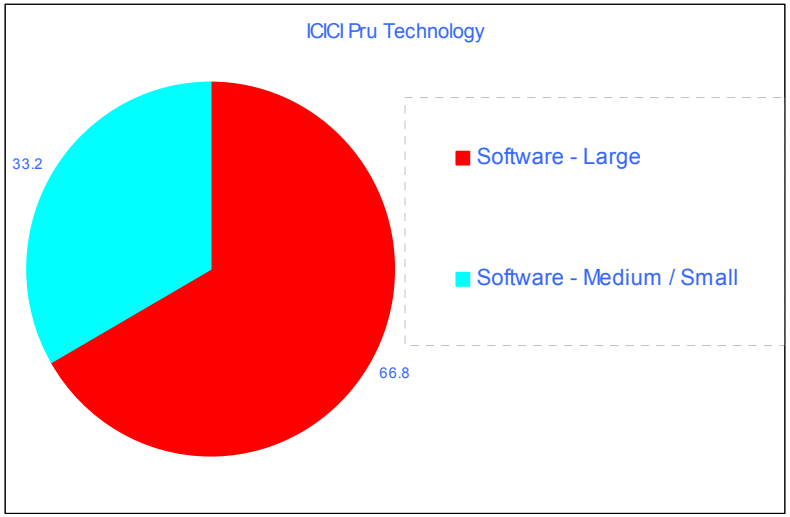


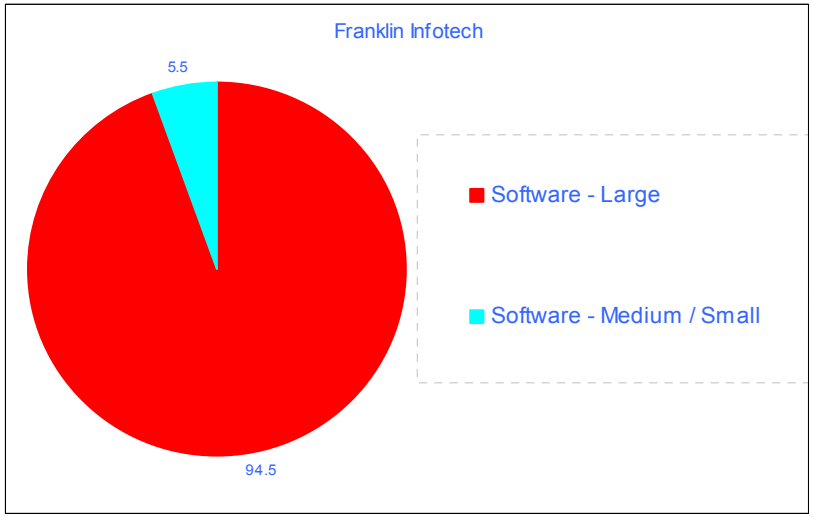
Mutual Fund Category Analysis contd…

Portfolio:

The schemes in the category invest predominantly in technology and technology dependent companies including hardware, peripherals and components, software, telecom, telecommunications, media and entertainment, internet and e-commerce and other technology-enabled companies. Higher exposure towards the large cap stocks of the software technology stocks has been witnessed while looking at the latest portfolios of all the schemes. There is an average of 80% of the net assets invested in such stocks as of March 2012. ICICI Pru Technology is the only scheme which allocated comparable higher exposure to mid and small cap software stocks (33%). Infy, TCS and Wipro are the most preferred stocks by the schemes as the schemes hold Rs. 152 crore, Rs. 61 crore And Rs. 32 crore respectively (as per March 2012). Franklin Infotech Fund and ICICI Pru Technology Fund are more concentrated within the sub-categories as far as asset allocation is concerned as both the schemes invest only in software stocks. Birla Sun Life New Millennium Fund, DSP BR Technology.com and SBI Magnum SFU - Infotech Fund have been broad in allocating the assets within the sub-categories along with software in Hardware, Entertainment & media Software and Telecom services.

Sector break up by the main schemes:





Mutual Fund Category Analysis contd…

The category seems to be risky as compared to equity diversified schemes as per the standard deviation which was calculated for last one year period. The standard deviation for the category is at 1.45% while the standard deviation for equity diversified is at 1.06%.

The AUM of the category stood as on 31 March 2011 at Rs. 358 crore. Average expense ratio as per latest data was at 2.49%. Exit load is charged by the schemes as 1% if the units are redeemed before one year of allotment. The schemes in the category display less churning as the average turnover ratio of the category was at 36.68%.

Analyst: Dhuraivel Gunasekaran.

(Database sources: AMC Sites, NAVIndia and Ace MF)

HDFC Securities Limited, I Think Techno Campus, Bulding –B, "Alpha", Office Floor 8, Near Kanjurmarg Station,
Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone (022) 30753400 Fax: (022) 30753435

Disclaimer: Mutual Fund investments are subject to risk. Past performance is no guarantee for future performance. This document has been prepared by HDFC Securities Limited and is meant for sole use by the recipient and not for circulation. This document is not to be reported or copied or made available to others. It should not be considered to be taken as an offer to sell or a solicitation to buy any security. The information contained herein is from sources believed reliable. We do not represent that it is accurate or complete and it should not be relied upon as such. We may have from time to time positions or options on, and buy and sell securities referred to herein. We may from time to time solicit from, or perform investment banking, or other services for, any company mentioned in this document. This report is intended for non-Institutional Clients.